Hot Topics in Cases Involving Distressed Companies

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RECENT DEVELOPMENTS INVOLVING FIDUCIARY DUTIES

I. EXAMINING ENRON BREACH OF FIDUCIARY DUTY CLAIMS IN ERISA SUIT

On September 30, 2003, Judge Melinda Harmon, United States District Judge for the Northern District of Texas, Houston Division, issued a 329 page ruling that permitted the breach of fiduciary claims to withstand motions to dismiss by Ken Lay and Northern Trust Co. ("Northern Trust"). See In re Enron Corp. Securities, Derivative & ERISA Litigation, 2003 WL 22245394 (S.D.Tex. Sep 30, 2003). This decision requires careful consideration of, first, who is a fiduciary for purposes of ERISA and, second, the fiduciary duties owed by ERISA plan fiduciaries and trustees when a company experiences financial distress and the threat of a decline in share price.

A. Summary of Complaint[2]

1. Four different groups of employees, including employees who were participants in three employee benefit plans governed by ERISA, asserted causes of action against multiple defendants[3] under nine counts: five under ERISA, two under RICO, one under Texas common law negligence and one under Texas common law conspiracy. This summary focuses on the breach of fiduciary duty claims asserted against Ken Lay and Northern Trust Co. ("Northern Trust") since the RICO and common law conspiracy claims against Mr. Lay were dismissed.[4]

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[2] All page references are to Judge Harmon's decision as reported in Westlaw unless otherwise specified.

[3] The defendants fall into five general categories: (i) Enron and its individual officers and directors; (ii) the committees, trustees and individuals that administered the pension plans; (iii) Arthur Andersen LLP, Enron's accountant, and certain of Arthur Andersen's individual partners and employees; (iv) Vinson & Elkins, L.L.P., Enron's outside law firm, and certain of Vinson & Elkins' individual partners; and (v) five investment banks, J.P. Morgan Chase & Co., Merrill Lynch & Co., Inc., Credit Suisse First Boston, Citigroup, Inc., and Salomon Smith Barney, Inc.

[4] The complaint was dismissed as to the RICO and common law conspiracy claims against the investment banks and Vinson & Elkins, L.L.P. The complaint was dismissed as to all claims against Arthur Andersen LLP and certain of

2. The complaint asserts that Ken Lay was Chairman of the Board of Directors, served as Enron's CEO from 1986-February 2001 and was a fiduciary of the Enron Corporation Savings Plan (the "Savings Plan"), the Enron Corporation Employee Stock Ownership Plan (the "ESOP") and the Enron Corporation Cash Balance Plan (the "Cash Balance Plan"). *1 at n. 5.

3. The complaint asserts that Northern Trust Co. was a trustee and fiduciary of the Savings Plan and the ESOP within the meaning of 29 U.S.C. § 1002(21)(A)[5] and that Northern Trust exercised authority and control over plan assets by imposing a lockdown, or freeze, on the sale of Enron stock in the plans, and that by not stopping or delaying the lockdown, Northern Trust breached its fiduciary duties to plan participants. *1 at n. 10.

4. Count I, on behalf of the Savings Plan and the ESOP, asserts that a number of defendants, including Mr. Lay and other senior officers of Enron, knew or should have known that Enron stock was an imprudent investment choice and that they breached their fiduciary and co-fiduciary duties of loyalty, prudence and care under 29 U.S.C. §§ 1104(a)(1)(A) - (D)[6] and 1105 for, among other things:

(..continued)
its named partners and employees other than Count I (ERISA) and the common law negligence complaint. The complaint was dismissed as to a number of the other defendants as to some or all of the counts. See pp. 325 - 329.

[5] 29 U.S.C. § 1002(21)(A) provides as follows:

> Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan…

[6] This provision sets forth the prudent man standard of care as follows:

> (a) Prudent man standard of care
>
> (1) … [A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and--
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and

(a) inducing participants to direct the fiduciaries to purchase Enron stock;

(b) causing and permitting the Savings Plan to purchase or accept Enron's matching stock in the form of Enron stock;

(c) imposing restrictions on participants' ability to direct the Savings Plan fiduciaries to transfer both Savings Plan and ESOP assets out of Enron stock; and

(d) inducing the Savings Plan and ESOP participants to direct or allow the fiduciaries of both Plans to maintain holdings in Enron stock. *1.

5. Count II, on behalf of the Savings Plan and the ESOP against, among others, Mr. Lay and Northern Trust, assets that the defendants breached their fiduciary duties under 29 U.S.C. §§ 1104(a)(1)(A) - (D) and 1105 for prohibiting the sale of Enron stock during the lockdown period from October 17, 2001 to November 14, 2001 without adequate notice to participants, during which time the price of Enron stock declined from $33.84 per share to $10.00 per share. *2.

6. Count III, on behalf of the Savings Plan, asserts a breach of fiduciary duty in violation of 29 U.S.C. § 1104(a)(1)(D) against, among others, senior officers of Enron (including Mr. Lay), and Northern Trust, for their failure to diversify the Savings Plan assets by liquidating holdings in Enron stock in accordance with the terms of the Plan because the defendants knew or should have known that the investment in Enron stock was imprudent. *2.

(..continued)

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.

7. Count V, on behalf of the Savings Plan the ESOP and the Cash Balance Plan, asserts that Mr. Lay and others breached their fiduciary and co-fiduciary duties under 29 U.S.C. § 1104(a)(1)(A) - (D) and § 1105 by:

(a) Appointing fiduciaries to manage Plan assets that the Defendants knew or should have known were not qualified to manage Plan assets loyally and prudently;

(b) Failing to monitor adequately the investing fiduciaries' investment of these assets;

(c) Failing to monitor adequately the Plans' other fiduciaries' implementation of the Plans' terms, including investment of assets;

(d) Failing to disclose to the investing fiduciaries material facts concerning Enron's financial condition that they knew or should have known were material to loyal, prudent investment decisions concerning the use of Enron stock in the Plans;

(e) Failing to remove fiduciaries who Defendants knew or should have known were not qualified to manage the Plans' assets loyally and prudently;

(f) By knowingly participating in the investing fiduciaries' breaches by accepting the benefits of those breaches;

(g) By knowingly undertaking to hide acts and omissions of the fiduciaries that Defendants knew constituted fiduciary breaches; and

(h) By failing to remedy those fiduciaries' known breaches. *3; *98 at n. 141.

B. Requirements of Plan Fiduciaries

1. First identifying the definition of fiduciary under ERISA as expansive, Judge Harmon explained that a person or entity may be deemed a fiduciary either by assuming fiduciary obligations or by being expressly identified as a fiduciary in ERISA plan documents. *7. Judge Harmon cited several Circuit Court decisions for the proposition that fiduciary status under ERISA is to be "construed liberally," and that fiduciary obligations under ERISA "can apply to managing, advising and administering an ERISA plan." *7 (citations omitted). Even though a plan fiduciary may wear several hats, Judge Harmon emphasized that the "most fundamental duty of ERISA plan fiduciaries is a duty of complete loyalty … to insure that they discharge their duty" exclusively in the interests of the plan participants and beneficiaries and to exclude any self-interest and consideration of third party interests. *9.

2. Second, Judge Harmon pointed out that a plan fiduciary must satisfy the prudent man standard of 29 U.S.C. § 1104(a)(1)(B). This standard requires a fiduciary to "act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man in a like capacity and familiar with such matters would use". Judge Harmon rejected the notion that good faith is a defense to a claim of having acted imprudently. *10.

3. Third, unless it is clearly prudent not to diversify plan assets, an ERISA fiduciary must diversify the plan's investments to minimize risk of loss. *11. To prevail on a claim of lack of diversification, the plaintiff needs to show that the portfolio, on its face, lacks diversification; the burden then shifts to the defendant to prove that it was "clearly prudent" not to diversify. *11.

4. Fourth, the plan fiduciary is required to follow the documents governing the plan, but only to the extent that they are not inconsistent with ERISA. *11.

C. The standard of care under the "two hat" doctrine; the consequence of having the power to appoint and remove plan fiduciaries; whether plan fiduciaries have a duty to disclose information about the company's financial performance and condition to plan participants and beneficiaries; and whether causation must be plead and the standard for co-fiduciary liability.

1. <u>"Two Hat" Doctrine</u>. In asserting a breach of fiduciary duty claim, Judge Harmon pointed out that the "two hat" rule of ERISA law permits a fiduciary to "wear" many hats, but only one at a time; and the only hat the fiduciary may wear when making decisions relating to an ERISA plan is that which places the financial interests of plan participants and beneficiaries first and foremost. So, when a plaintiff alleges a breach of fiduciary duty, courts must initially determine whether the defendant was acting as a fiduciary when the action complained of was performed. *12.

2. <u>Power to Appoint and Remove Plan Fiduciaries.</u> To the extent that a person or entity has the power to appoint, retain and/or remove a plan fiduciary, that person or entity is a fiduciary to the extent that such power is exercised. Judge Harmon reasoned that fiduciary liability exists because of the discretionary authority or control over the management or administration of the plan. *14.

3. Duty to Disclose. Recognizing that a fiduciary's duty to disclose is an unsettled area of ERISA law, Judge Harmon explained that courts have been recently broadening a fiduciary's duty to disclose material information to ERISA plan participants. Starting from the unchallenged notion that a plan administrator is acting in its capacity as a fiduciary when it explains current plan benefits to employees, Judge Harmon reasoned that the duty likely applies when describing future benefits as well. Judge Harmon cited the Supreme Court case of Varity Corp. v. Howe, 516 U.S. 489 (1996) as authority for the proposition that ERISA requires plan fiduciaries to not miscommunicate or mislead plan participants about any material issue concerning an ERISA plan. The materiality threshold is met if the misstatements would induce a reasonable person's reliance. After examining the law of other circuits, including the Third Circuit which imposes a *per se* breach of fiduciary duty if an employer knowingly makes a material misleading statement about the stability of a benefits plan, Judge Harmon explained that the Fifth Circuit appears to impose a fiduciary duty to disclose more cautiously. *15-18.

4. Causation. Although bound by the Fifth Circuit, Judge Harmon explained the different standard articulated by the Sixth and Second Circuits (which require plaintiffs to plead causation) and the Fifth and Eighth Circuits (which require the plaintiff to prove a fiduciary duty breach and a loss by the plan, after which the burden shifts to the defendant fiduciary to prove that the loss was not the result of a fiduciary duty breach). *****33.

5. Co-fiduciary Liability. Judge Harmon summarized the liability of co-fiduciary by explaining that a person must be a fiduciary in order to be liable as a co-fiduciary. As a co-fiduciary, one fiduciary can be liable for the other fiduciary's breach of duty. In the absence of authority and control over the management of a plan or its assets, a person cannot be liable as a co-fiduciary. *33-34.

D. Application of rulings to defendants Lay and Northern Trust.

1. As to Mr. Lay, Judge Harmon let stand all of the counts against him, except a claim under Count I for the fraudulent promotion of Enron stock.

(a) Judge Harmon found that the plaintiffs had sufficiently plead that Mr. Lay had breached his fiduciary duty of loyalty under ERISA by failing to disclose information that he knew or should have known about Enron's precarious financial situation while a number of the defendants were selling large portions of their Enron stock holdings. In particular, Judge Harmon cited Mr. Lay's sale of substantial amounts of Enron stock while encouraging plan participants and beneficiaries at meetings and through e-mails to purchase Enron stock as a result of Enron's financial strength. Judge Harmon let stand the counts against Mr. Lay in part because he purportedly misrepresented that Enron's accounting for its off-balance sheet partnerships and single purpose vehicles was approved by all of Enron's internal offices and external counsel and auditors. Also harmful to Mr. Lay's motion to dismiss were the allegations that he encouraged plan participants to direct the Savings Plan and ESOP fiduciaries to purchase and hold stock in Enron even though he knew or should have known that it was not a prudent investment option. *102-103.

(b) Judge Harmon concluded that the plaintiffs had stated claims against Mr. Lay and others for failing to (i) investigate adequately, (ii) provide material information or correct misleading information essential to prudent plan administration, (iii) monitor or remove appointees for incompetence and (iv) direct the trustee regarding prudent plan asset investment. *104. Similarly, she concluded that the plaintiffs had alleged sufficient facts to support a claim of co-fiduciary liability for, among other things, knowingly participating or concealing their knowledge of and/or failing to take reasonable steps to remedy their co-fiduciaries' breach of fiduciary duties. *106.

(c) In reaching her decision, Judge Harmon rejected a *per se* rule that corporate officers cannot be personally liable when acting on behalf of the corporation. She ruled that a fact-specific inquiry was necessary to assess "the extent of responsibility and control exercised by the individual with respect to the Plan" to determine whether the corporate employee - and the corporation - has exercised such discretionary authority and control to be deemed an ERISA fiduciary and, therefore, personally liable for the breach of fiduciary duty. *24-25.

2. Judge Harmon also let stand the counts of the complaint as they pertain to Northern Trust.

(a) Regarding Northern Trust, Judge Harmon explained that the plaintiffs asserted that Northern Trust was either a discretionary trustee or a directed trustee. As a discretionary trustee, the plaintiffs alleged, Northern Trust exercised discretionary authority and control over plan assets when it imposed the lockdown even though it had the power to postpone the lockdown until Enron's stock price stabilized to avoid harm to the plan participants and that Northern Trust should have known that proceeding with the scheduled lockdown would be harmful. Alternatively, if Northern

Trust was a directed trustee (as Northern Trust contended), Northern Trust breached its fiduciary duties in following lockdown instructions given to it by the Administrative Committee of the ESOP because the directions conflicted with ERISA and Northern Trust knew or should have known that the instructions violated ERISA. *35-38; *108.

(b) Without deciding whether Northern Trust was a directed trustee or a discretionary trustee, Judge Harmon focused on whether and, if so, to what extent, a directed trustee is a fiduciary as defined by 29 U.S.C. § 1002(21)(A), and therefore subject to the standards, duties and obligations of an ERISA fiduciary under 29 U.S.C. §1104(a)(1). *35. Judge Harmon concluded that even when a named fiduciary appears to have full control, authority and/or discretion over plan management and/or plan assets, the directed trustee still retains enough discretion, authority and responsibility that may create liability. Judge Harmon concluded that the plaintiffs had stated a claim against Northern Trust as a directed trustee, since, based on the allegations, Northern Trust knew or should have known "from a number of significant waiving red flags and/or regular reviews of the company's financial statements that the employer company was in financial danger and its stock greatly diminished in value." *53. The Court concluded that the plaintiffs sufficiently plead a claim since they alleged that any order to proceed with a lockdown on its face violated the duties of prudence and loyalty since the timing of the order was highly suspect and injurious to plan participants. *53; *108-110.

(c) Plaintiffs also sufficiently plead a claim against Northern Trust, among others, for failure to diversify the Savings Plan assets in accordance with the plan provisions and ERISA. Specifically, the plan assets were "dangerously over weighted in Enron stock" since this holding accounted for more than 60% of its investments. *113.

II. DIRECTORS AND CONTROLLING SHAREHOLDERS MAY BE LIABLE FOR BREACH OF FIDUCIARY DUTIES IN CONNECTION WITH MERGER OR LBO

A. General Principles of Fiduciary Duties

1. When a corporation is solvent, the directors owe fiduciary duties to stockholders. It is the stockholders who own the corporation and who have entrusted the directors with control and management of their property. Directors of a solvent company do not owe fiduciary duties to creditors. The relationship between directors and creditors of a solvent corporation is contractual in nature. In re Hechinger Inv. Co. of Del., 274 B.R. 71, 89 (D.Del. 2002).

2. When a corporation becomes insolvent, "the fiduciary duty of directors shifts from the stockholders to the creditors." FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983). "Since the liability of shareholders is limited to their investments, anything the managers do to increase or decrease shareholder equity is primarily to the benefit or detriment of the creditors, rather than the shareholders, until the corporation regains solvency." In re Ben Franklin Retail Stores, Inc., 225 B.R. at 653 n. 13. Stated differently, in an insolvency, the directors are "playing with the creditors' money." Hechinger, 274 B.R. at 89.

3. Directors of a corporation "in the vicinity" of insolvency owe a duty to creditors to "maximize the corporation's long-term wealth creating capacity." Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613, *34 (Del. Ch. Dec. 30, 1991). At least under Delaware law, directors (and officers) owe fiduciary duties to creditors at a point short of actual insolvency. Pereria v. Cogan, 294 B.R. 449, 519 (S.D.N.Y. 2003) (applying Delaware law). Accordingly, directors of a company in the vicinity of insolvency owe fiduciary duties to not just shareholders but to the corporation's community of interests. Yet there is no test to pinpoint when a company is in the vicinity of insolvency.

B. Fiduciary Duties in Merger Context. In the case of Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 919 (Del. 2003), the Delaware Supreme Court held that the terms of a proposed merger, a merger agreement and voting agreements were inconsistent with the directors' fiduciary duties and, accordingly, were invalid and unenforceable. Id. at 939.

1. Facts:

(a) NCS was an insolvent publicly traded Delaware corporation which was the object of competing merger proposals, one by Genesis Health Ventures, Inc., and another by Omnicare, Inc.

(b) Initially, the NCS board of directors agreed to merger terms with Genesis, pursuant to which all NCS creditors would be paid in full and the corporation's stockholders would exchange their shares for shares of Genesis. In negotiating the transaction, Genesis refused to proceed with the transaction unless the NCS board agreed to three separate "deal protection devices":

(i) the NCS board, at the insistence of Genesis, was prohibited from including a "fiduciary out" clause in the merger agreement;

(ii) the agreement must include a provision (authorized by Section 251(c) of Delaware corporation law) requiring that the NCS stockholders be permitted to vote on the merger, even if the board subsequently elected to withdraw its support; and

(iii) in connection with the merger agreement, two stockholders of NCS, who collectively owned more than 65% of outstanding NCS stock, must agree irrevocably to vote their shares in favor of the Genesis agreement.

(c) Shortly after executing the merger agreement with Genesis, NCS received an offer from Omnicare that ultimately resulted in Omnicare making an irrevocable tender offer to NCS on terms which would provide NCS stockholders with more than twice the value for their NCS shares than would have been tendered pursuant to a merger with Genesis. The Omnicare and Genesis transactions provided equal terms to remaining NCS stakeholders.

(d) After considering the terms of the Omnicare offer, the NCS board of directors withdrew its support for the Genesis bid and recommended that the stockholders vote to reject the Genesis proposal. Nevertheless, NCS conceded in a filing with the SEC that its contractual obligations to Genesis pursuant to the merger agreement, combined with the terms of the contemporaneously executed voting agreements, conclusively ensured that the Genesis merger would be approved by the NCS stockholders.

2. Legal Developments

(a) In two separate proceedings, both Omnicare and a class of NCS stockholders sought to invalidate the merger agreement between NCS and Genesis on the grounds that the NCS board had violated its fiduciary duties by entering into an exclusive agreement with Genesis. The class action plaintiffs asserted that the directors violated the fiduciary duty of care "in failing to establish an effective process designed to achieve the transaction that would produce the highest value for the NCS stockholders." Omnicare, 818 A.2d at 919.

(b) The Court of Chancery rejected both plaintiffs' petitions to invalidate the merger, refusing to grant a preliminary injunction and finding that the deal protection devices contained within the agreement were reasonable. In re NCS Healthcare, Inc., Shareholders Litigation, 825 A.2d 240 (Del. Ch. 2002); Omnicare, Inc. v. NCS Healthcare, Inc., 825 A.2d 264 (Del. Ch. 2002).

3. Pre-Omnicare Standard

(a) In general, "the business judgment rule, as a standard of judicial review, is a common-law recognition of the statutory authority to manage a corporation that is vested in the board of directors." MM Companies v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003). In applying this rule, however, Delaware courts have come to recognize that certain circumstances compel courts to "take a more direct and active role in overseeing the decisions made and actions taken by directors," thereby resulting in "enhanced scrutiny" of any decisions made by a board of directors, where such circumstances are presented, before the business judgment rule may be applied. Omnicare, 818 A.2d at 928 (internal citations omitted). Defensive devices that are invoked to protect a merger transaction, even where no change in control will take place as a result of the transaction, present the type of circumstances which require such enhanced scrutiny. Id. at 931 (citing Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1151-55 (Del. 1989).

(b) The proper factors to be applied in determining whether a board's actions are to be awarded the safe haven of the business judgment rule were set forth most comprehensively in the case of Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

(i) In earlier cases involving "deal protection measures", Delaware courts held that such protections were not, *de facto*, impermissible, but rather that "such devices are properly subject to a Unocal analysis." Paramount Communications, Inc., at 1150.

(ii) A Unocal analysis requires directors (1) to establish that the defensive measures (or deal protection devices) being challenged are neither "preclusive" nor "coercive," and, only once the first prong is met, (2) to ensure that their "response was within a 'range of reasonable responses' to the threat perceived." Omnicare, 818 A.2d at 934-935 (quoting Unitirin, Inc. v. Am.Gen. Corp., 651 A.2d 1361, 1387-1388 (Del. 1995)).

(c) These pre-Omnicare cases emphasized that such an inquiry was, by its very nature, a fact-sensitive determination, and did not preclude the adoption of any specific deal protection device as a violation of fiduciary duty. See Brazen v. Bell Atl. Corp., 695 A.2d 43, 50

(Del. 1997) citing Williams v. Geier, 671 A.2d 1368, 1383 (Del. 1996).

4. Post-Omnicare Standard

(a) Omnicare is a significant departure from earlier cases owing to the Delaware Supreme Court's unambiguous declaration that a board of directors may not agree to deal protection measures that operate to deprive it of its power to satisfy its ongoing fiduciary obligations. The Omnicare Court stated that, "[n]otwithstanding the corporation's insolvent condition, the NCS board had no authority to execute a merger agreement that subsequently prevented it from effectively discharging its ongoing fiduciary responsibilities." Omnicare, 818 A.2d at 938.

(b) The Omnicare Court examined the three deal protection measures presented in the case in concert, and found that, because these measures operated to make the Genesis merger a *fait accompli*, both depriving the board of any opportunity to consider more attractive offers in the future and depriving NCS minority stockholders of their legally guaranteed rights to consider and reject the terms of a proposed merger, the merger agreement and voting agreements were incompatible with the directors' fiduciary duties and are thereby invalid and unenforceable. Id., at 939.

(c) According to the Omnicare decision, therefore, a board must leave itself the opportunity to consider subsequent offers in order to satisfy its ongoing fiduciary obligations. As written, Omnicare essentially operates to prohibit any agreement between a board of directors and a prospective merger partner that serves to "lock-up" a prospective transaction and, accordingly, to deprive the board and the minority stockholders of any further power to affect the corporation's actions.

5. Is Omnicare the Final Word on Fiduciary Duties in the Takeover Arena?

(a) Probably not. The controversy of the Omnicare decision is further heightened by the fact that it was not a unanimous decision.

(b) The ruling was a fairly unusual 3-2 decision in which the dissenters wrote a strongly worded dissenting opinion. In their opinion, the dissenters branded the majority opinion "clearly erroneous," affirmatively expressed their hopes that the majority rule "will be interpreted narrowly and will be seen as *sui generis*," and that its future application will be limited by the unique facts of the case. Id. at 946.

C. Fiduciary Duties in the LBO Context. In In re Hechinger Inv. Co. of Del., 274 B.R. 71, 89 (D.Del. 2002), the Delaware District Court, on a motion to dismiss, ruled that claims for breach of fiduciary duty by the debtors' directors and certain of the controlling shareholders as a result of their decisions in connection with the leveraged buyout which precipitated the debtor's bankruptcy filing could proceed.

1. Facts

(a) Prior to 1997, Hechinger Company ("Hechinger") was a major retailer of products and services for home improvement, modeling and maintenance. Two families controlled 70% of the voting stock even though they did not own a majority of the outstanding stock due to Hechinger's issuance of two classes of stock. Between 1983 and 1996, Hechinger rapidly expanded its business. In the face of increasing competitive pressures, Hechinger closed some of its stores in 1995 and, between February 4, 1997 and September 27, 1997 - the date when the LBO was consummated - posted losses of $206 million. Hechinger, 274 B.R. at 76 - 77.

(b) The plaintiffs alleged that at the time of the LBO, Hechinger was already highly leveraged. An LBO specialist acquired Hechinger in a two-step merger transaction which considerably increased Hechinger's debt load and, within two years of the LBO, Hechinger filed for bankruptcy.

2. Legal Developments

(a) The Official Committee of Unsecured Creditors filed its complaint, naming those directors who were Hechinger's directors at the time of the LBO as defendants. In the complaint, the committee alleged that the directors breached their fiduciary duties to creditors. Id. at 89.

(b) The District Court observed that the case was unusual in that it alleged that directors breached their fiduciary duties to creditors. Id at 89. The District Court brushed aside the directors' arguments that they only approved the merger step of the LBO and not the subsequent pledging of assets which allegedly enhanced or caused Hechinger's insolvency. The court explained that "courts have found that a set of transactions may be viewed as one integrated transaction if the transactions reasonably collapse into a single integrated plan and either defraud creditors or leave the debtor with less than equivalent value post-exchange." Id at 90 - 91 quoting CPY Co. v. Ameriscribe Corp., 145 B.R. 131, 137 (Bankr. S.D.N.Y. 1992) (internal quotes omitted). In denying the motion to dismiss, the court ruled that the mere structure of the transaction, without more, did not merit the dismissal of the breach of fiduciary duty claims, especially where the committee had alleged that the harm was the foreseeable result of the directors' actions. Id. at 92.

(c) As to the controlling shareholders, the District Court explained that they, too, have fiduciary duties. Id. at 93 citing Harris v. Carter, 582 A.2d 222, 234 (Del. Ch. 1990). The court explained that controlling shareholders have fiduciary duties since their control of the company can cause the corporation to enter into transactions that are harmful to the company but benefit the shareholders. However, if a controlling shareholder is restricted from voting its stock due to the existence of a voting arrangement or a proxy, then it cannot be liable for a breach of fiduciary duty. Id. at 94.

3. Consequences of Hechinger

(a) Hechinger reinforces earlier decisions of U.S. v. Tabor Court Realty Corp., 803 F. 2d 1288 (3rd Cir. 1986), Brandt v. Hicks Muse & Co. (In re Healthco Int'l, Inc.), 195 B.R. 971 (Bankr. D.Mass. 1996) and Wieboldt Stores v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988) in holding that even if the transactions are not ultimately found to be collapsible, there may be a cause of action for breach of fiduciary duty based on the foreseeability of the alleged harm to creditors. Id. at 92.

(b) Regarding controlling shareholders, if the controlling shareholder has relinquished its right to vote on the transaction that gives rise to a claim for breach of fiduciary duties, courts should dismiss the claim since the shareholder lacked the power to take any action that would result in the breach.

COULD A RECENT RECHARACTERIZATION DECISION DETER FINANCING FOR DISTRESSED COMPANIES?

I. IN RE OUTBOARD MARINE CORP., 2003 U.S. DIST. 12564 (E.D. IL. JULY 21, 2003) RENEWS THE QUESTION OF WHETHER LENDERS TO DISTRESSED COMPANIES WILL BE DETERRED FROM TRYING TO SAVE A COMPANY FROM A POTENTIAL BANKRUPTCY FILING

A. Facts of OMC

1. In the Fall of 2000 and in failing financial health, Outboard Marine Corporation ("OMC") obtained a $45 million secured loan from Quantum Industrial Partners, LDC ("Quantum"). During the two preceding years, Quantum acquired nearly all of OMC's stock. Quantum's secured debt was junior to $105 million of preexisting secured debt. Quantum relinquished its legal rights against OMC to the existing lead secured lender in connection with making its loan.

2. Within two months of receiving the proceeds of Quantum's loan, OMC filed for bankruptcy and Quantum found itself on the defense in an action to recharacterize its debt as equity. The court identified two ways of potentially reordering Quantum's priority in the distribution scheme - recharacterization and equitable subordination

B. Recharacterization

1. Recharacterization has its genesis in tax cases. See Roth Steel Tube Co. v. C.I.R., T.C. Memo. 1985-58, 1985 WL 14691, (U.S. Tax Ct. Feb 07, 1985) aff'd Roth Steel Tube Co. v. C.I.R., 800 F.2d 625 (6th Cir. 1986). Courts determine that, due to the inherent nature of the "loan", the lender is not really a lender, but an equity contributor who dresses up its equity to look like debt.

2. Recharacterization differs from equitable subordination, which usually results from misconduct of the creditor.

C. Equitable Subordination

1. The concept of equitable subordination is codified in section 510(c) of the Bankruptcy Code.

2. Section 510(c) is one of the bankruptcy court's general equity powers conferred on it by the Bankruptcy Code that enables it to prevent an unjust or unfair result in the distribution process.

(a) The two predominant factors courts analyze to determine equitable subordination are:

(i) whether the creditor engaged in some type of inequitable conduct; and

(ii) whether the misconduct resulted in injury to creditors or conferred an unfair advantage on the creditor.

(b) The level of misconduct differs for insiders and third parties.

(i) The misconduct must be egregious if it involves third parties and the party complaining of the misconduct must carry this burden.

(ii) If the transaction complained of involves an insider, the insider will be required to prove that the transaction was intrinsically fair to the company.

D. <u>Recharacterization Factors</u>

1. These are the factors courts typically examine in connection with determining whether to recharacterize debt as equity:

(a) name given to instrument that evidences the indebtedness (the issuance of a stock certificate indicates an equity contribution, whereas the issuance of a bond, debenture or note is indicative of a bona fide indebtedness);

(b) presence or absence of a fixed maturity date and payment schedule (the presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation);

(c) repayment source (if repayment is dependent on corporate earnings, the transaction has the appearance of a capital contribution);

(d) presence or absence of a fixed rate of interest and interest payments (lack of provisions for payment of interest indicates that the money advanced was intended as a capital contribution);

(e) right to enforce payment of the principal and interest (if there is a definite obligation to repay the advance, this would be an indicator of a loan);

(f) participation in management as a result of the transaction (if the contributors were granted increased voting power or participation in the debtor's affairs by virtue of the advance, this would be an indicator of a capital contribution);

(g) extent to which the advances were subordinated to the claims of outside creditors (subordination of advances to claims of all other creditors indicates that the advances are capital contributions and not loans);

(h) intent of the parties (intent to create either a debt or equity relationship);

(i) "thin" or inadequate capitalization (thin capitalization is indicative of a capital contribution);

(j) identity of interest between creditor and stockholder (a sharply disproportionate ratio between a shareholder's percentage interest in stock and debt is indicative of a debt obligation);

(k) ability of the corporation to obtain loans from outside lending institutions (if a corporation is able to borrow funds from outside sources at the time the advance is made, the transaction is indicative of a debt transaction);

(l) extent to which the corporation used the advance to acquire capital assets (use of advances to meet the daily operating needs of the corporation, rather than to purchase capital assets, is indicative of a bona fide indebtedness); and

(m) The failure of the debtor to repay debt on the due date or to seek postponement of repayment (repayment of the advance on the due date indicates a bona fide indebtedness). See Roth Steel Tube Co. v. C.I.R., 800 F.2d at 630.

2. Not all of these factors need be proven. And, courts sometimes identify other factors to which they ascribe significance.

E. Legal Determination

1. In reversing the bankruptcy court, the District Court concluded that recharacterization exists as a separate legal theory, independent from a bankruptcy court's ability to equitably subordinate claims under section 510(c) of the Bankruptcy Code. Outboard Marine, 2003 U.S. Dist. at *16-17.

2. The District Court explained that recharacterization involves a factual determination that the debt is not truly debt. Equitable subordination is, as its name implies, an equitable remedy. It is applied against a creditor who has acted to the detriment of other constituents. Id.

F. Implications of OMC

1. When contemplating making a loan to an entity in which the lender already has a significant equity stake, the lender should consider making the loan against the backdrop of these two theories. Inside of a chapter 11 proceeding, creditors are incented to push a lender down the food chain if it appears that the lender's loan suffers from some of the characteristics indicative of a transaction that may be recharacterized.

2. Additionally, lenders should be aware that, if they stand in the position of both lender and equity investor, they will likely be faced with the double-barreled shotgun approach of not only a recharacterization claim but an equitable subordination claim.

IMPACT OF SARBANES-OXLEY
ON DISTRESSED COMPANIES

Table Of Contents

CEO/CFO Certifications

§302 civil certification

- **Each company annually or quarterly reported, filed or submitted by any company**
- **To certifier's knowledge, periodic report:**
  - **contains no untrue/omitted material fact**
  - **fairly presents financial information in all material respects**

Certifier is responsible for internal controls and "disclosure controls and procedures"

CEO/CFO Certifications

§906 criminal certification

- Each SEC periodic report containing financial statements filed by any "issuer"
  - Periodic report must:
    - fully comply with 34 Act
    - fairly present information in all material respects
- Crime to certify "knowing" report doesn't comport with above
- Penalty for "knowing" false §906 certification:
  - Up to $1 MM and 10 years in prison.
  - If "willful" , up to $5 MM and 20 years in prison.

Who Is An "Issuer"

Company is "issuer" if it meets 1 of 4 tests:

1. Company has debt or equity securities registered on national securities exchange;
2. Company has 500 holders of equity class;
3. Company issued debt or equity securities by 33 Act registrant statement; or
4. Company filed 33 Act registration statement with SEC which is not yet effective and not yet withdrawn.

Summary Of How Certification Will Impact Distressed Companies

1. Increased vigilance by CEO and CFO in connection with financial disclosures.
2. Company less likely to provide bonuses to CEO/CFO in distressed situation if risk of restatement exists.
3. Board's fiduciary duties in insolvency or vicinity of insolvency may compel the company to initiate action against CEO/CFO for bonus and profit forfeiture via preference or fraudulent conveyance litigation.
4. Accounting restatement will likely force the resignation of the CFO/CEO.
5. Difficulty of obtaining certification leading up to and inside chapter 11.

§304 CEO/CFO Bonus & Profit Forfeiture

If "issuer" required to prepare accounting restatement due to material noncompliance with any final reporting requirements under securities laws as result of misconduct

THEN…

CEO & CFO must disgorge to issuer:

1) any bonus or other incentive-based or equity-based compensation received from company during 12 month period following issuance of erroneous financials; and
2) profits realized from sale of company securities during such 12 month period.

Open Questions

When is issuer required to prepare accounting restatement?

When is accounting restatement a result of material misconduct with reporting requirements?

Does material mean adverse?

What is misconduct?

Whose misconduct? And what if CEO or CFO hired after issuance of erroneous financials?

What Must Be Disgorged?

- Bonus received from issuer within 12 months after publication of erroneous financials
  - Salary? No
  - Bonus paid day before publication of erroneous finals? No
  - Bonus paid more than one year after publication of erroneous financials although related thereto? No

Practical Effect Of §304

1. Creates incentive for CEOs and CFOs to seek more salary instead of bonuses or incentive-based compensation
2. Increased salary will reduce bonus payments to CEOs and CFOs which creditors seek to recover as preferences in bankruptcy
3. Increased pressure on company and its accountants to avoid restatement

Board Of Directors And Board Committees

- Board and board committees with respect to companies listed on major U.S. exchanges:
  - All have published proposed rules on board membership/independence and board committees
  - Proposed rules will result in greater reliance on independent directors in restructuring and bankruptcy process

Board Of Directors And Board Committees

- Audit committee of listed companies:
  - 100% independent
  - authorized to engage independent counsel. Will increase counsel serving in distressed situations to potentially include counsel for:
    - Company
    - Board
    - Audit Committee
  - responsible for accountant appointment, compensation, oversight, and resolution of disagreements with management
  - establish procedures for receiving and responding to concerns about accounting, internal controls and auditing

IDENTIFYING TRENDS FOR FUTURE TROUBLED INDUSTRIES

IDENTIFYING FUTURE TROUBLED INDUSTRIES

Identifying Future Troubled Industries

1. **Energy/Utilities**
2. **Airlines**
3. **Automobile**
4. **Shipping**
5. **High Tech**
6. **Supermarkets**
7. **Real Estate**

What Factors Put Industries At Risk?

- **The Domino Effect**
- **Technological Innovations**
- **Commodization**
- **Regulatory Changes**
- **Management Issues**

Actions That Can Characterize At-Risk Industries

- One Time Asset Sales
- Operational Restructuring/Bankruptcies
- Issuance of High Yield Debt
- Frequent Management Turnover

Are these symptoms or solutions?

Actions That Can Characterize At-Risk Industries

Asset Sales

Are these companies just "burning the furniture to pay the rent?"

Many sectors are seeing asset sales:

- Energy
- Telecom
- Utilities
- High Tech

Actions That Characterize At-Risk Industries

Multiple Bankruptcy Filings

Signal of Inherent Weakness

Actions That Characterize At-Risk Industries

Issuance of High Yield Debt

Why Now?

High Yield Debt Market - Past Ten Years

New Issues of High Yield Bonds	
Year	**Total Cost of New Issues**
2003	**$151 Billion (projected)**
2002	$74 Billion
2001	$110 Billion
2000	$67 Billion
1999	$125 Billion
1998	**$161 Billion**
1997	**$153 Billion**
1996	$90 Billion (approximated)
1995	$45 Billion (approximated)
1994	$50 Billion (approximated)

Source: Securities Data Company, June 9, 2003; All High Yield Volumes, including 144a Issues

Increased Issuance of High Yield Debt: 1997-1999

According to Fitch Ratings, 40% of all junk bonds issued between the beginning of 1997 and the end of 1999 had defaulted by the end of June, 2002.

Source: Richard, Christine, High Yield Bull Bonds Packed risk, Wall Street Journal, October 10, 2002

High Yield Debt Market

Current Boom

Is it based on unreasonable optimism?

or

Will there really be a brighter tomorrow?

Current Junk Bond Boom is Concentrated in Lowest Rated Issuances

"CCC" rated bonds (lowest rating available) account for more than 57% of all defaults in the past ten years.

Bonds rated "CCC" account for just under 15% of recent high yield debt offerings.

Source: Securities Data Company, June 9, 2003; All High Yield Volumes, including 144a issues

PREDICTIONS FOR INDUSTRIES AT RISK